



Shadow Monetary Policy Committee

January 2013

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IEA's Shadow Monetary Policy Committee votes by seven to two to hold Bank Rate in January

In its most recent e-mail poll, finalised on 31st December, the Shadow Monetary Policy Committee (SMPC) decided by seven votes to two that Bank Rate should be held at ½% on Thursday 10th January. One dissenter wanted to raise Bank Rate by ½%, while another desired an increase of ¼%. Most SMPC members thought that there should be no additional Quantitative Easing (QE), given that annual broad money growth had recently picked up to 4% to 4¼%. However, additional QE might still be needed if this monetary acceleration went into reverse. More generally, unduly heavy handed financial regulation was seen as a major cause of the UK's weak money and credit growth. Using QE to offset regulatory shocks was a roundabout and undesirable way of stabilising the monetary aggregates. Less intrusive regulation, and reduced QE, was a simpler and better course.

Several SMPC members expressed their disquiet about the fiscal weakness revealed in the 5th December *Autumn Statement*. This made an unpropitious background to the conduct of monetary policy. In addition, the rapidly diminishing credibility of the official fiscal projections made it difficult for the Bank of England to carry conviction, especially given its history of inflation overshoots. With the volume of general government current expenditure in the third quarter of 2012 already 4.5% higher than the Chancellor had intended in 2010, it was also felt that Mr Osborne was already on 'Plan G' or 'Plan H', let alone the 'Plan B' advocated by Labour. Some SMPC members expressed reservations about the idea that nominal GDP targets should replace those for inflation. Nominal GDP targeting was a theoretically appealing concept but was likely to prove a nightmare to implement in practice.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 15th January 2013 and its minutes will be published on Sunday 3rd February. The next two SMPC e-mail polls will be released on the Sundays of 3rd and 31st March, respectively.

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Comment by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate and pause QE.

Bias: Adjust Bank Rate and QE to achieve appropriate growth in broad money.

Mildly favourable UK macroeconomic outlook for 2013

The UK's M4^{ex} broad money definition rose by 0.4% in October, the last month for which official money data are available at the time of writing (28th December). Over the six months to October, the annualized rate of growth of M4^{ex} was 6.2%, clearly above the norm over the last five years of the Great Recession and its sequel. The relative strength of money growth in the recent past has owed much to QE, which might be regarded as artificial. All the same, the numbers are consistent with a marked easing of balance-sheet strains throughout the British economy. Late 2012 has not been an exciting time for the British economy but cyclical excitements are to be avoided. Share prices have moved ahead, the housing market has improved, London commercial real estate is quite active and companies' expansion plans are not cash-constrained. Retailers have reported a satisfactory Christmas, albeit with a continuing shift from the High Street to web-based suppliers. Even unemployment has been falling. Given a mildly favourable international background, the UK macroeconomic outlook for early 2013 is also mildly favourable.

Persistent Budget deficits reflect weak government and Keynesian justifications are invalid

The persistence of the budget deficit at extremely high levels is a sign of weak government, not of fundamental economic weakness. Nevertheless, it may lead to the loss of the UK's triple-A credit rating. According to the *Autumn Statement*, 'public sector net borrowing' is to be £99bn in 2013/14, compared with £80bn in 2012/13. The rise in the deficit may be justified in Keynesian circles by the argument that aggregate demand will be stronger because of the rise in the budget deficit. However, there is no evidence whatsoever that – in recent decades in any major economy – the growth of demand has been positively correlated with changes in the cyclically-adjusted budget deficit, as the Keynesian argument requires.

US 'fiscal cliff'

It is now appropriate to make two brief comments on the international background. First, a great media hullabaloo about the USA's 'fiscal cliff' seems to have persuaded some participants in financial markets that the US economy and, hence, a large part of the world economy may fall into another recession in 2013. May I simply repeat my observation in the last paragraph, that 'there is no evidence whatsoever that – in recent decades in any major economy – the growth of demand has been positively correlated with changes in the cyclically-adjusted budget deficit, as the Keynesian argument requires'? Far more important to the US cyclical prospect are recent and imminent movements in key asset prices – i.e., the prices of real estate and quoted equity – and critical to these movements are the quantity of money, broadly-defined, and hence the behaviour of the banking system. Although the US banking system, like others in the G20 nations, is unfortunately subject to the misguided Basle III rules, US broad money is growing at present, if only slowly. Moreover, the Conference Board's leading indicator index is rising gently. In my opinion, US economic activity would be little affected in 2013 by a large fall in the Federal deficit. Furthermore, the USA's financial image would be greatly enhanced by a big move back towards a balanced budget over the medium term.

Eurozone break up fears likely to return ahead of September 2013 German election

Secondly, fears of a Eurozone rupture have abated since spring 2012, largely because Germany, in particular, has shown increased willingness to underwrite debt issuance in the Club Med countries. However, Eurozone break-up fears will probably return at about the time of the German elections in September 2013, when German taxpayers realize the scale of the contingent liabilities now being incurred to their potential cost and have the opportunity to pass judgement on the subject. More fundamentally, the trend rate of economic growth in the Eurozone (i.e., Western Europe without the UK, more or less) is now pitifully low, perhaps even indistinguishable from zero. This low or negligible trend growth rate will constrain the demand for the UK's exports in 2013, but growth outside the EU – particularly in Asia – should revive after a rather mediocre 2012. Overall, the global outlook for UK companies, which are increasingly refocusing away from the EU, is fine.

No hurry to raise Bank Rate but policy goal should be stable broad money growth

My view on monetary policy is the same as at the end of November. There is no hurry to move to a higher level of short-term interest rates for the present, although I find it possible that I will be advocating a rise in interest rates in 2013. As ever, the overriding objective should be stable growth of the quantity of money at a low non-inflationary rate. QE has been paused, partly because of the slight upturn in broad money growth. However, the 'monetary authorities' (i.e., the Bank of England, the Treasury and the Debt Management Office as a Treasury agency) need at all times to coordinate the management of the public debt, so that the state's transactions in public debt help in maintaining a low and stable rate of money growth.

Comment by Jamie Dannhauser

(Lombard Street Research)

Vote: Hold Bank Rate; no change in asset purchases.

Bias: Expansion of QE, including purchase of non-gilt assets.

Recent data suggests that UK economy is only 'bumping along the bottom'

The decision regarding additional monetary ease was a close call this month. UK output growth remains sluggish. Although the recent volatility in monthly data series makes it tricky to ascertain the underlying strength of demand and economic activity, there is scant evidence that the economy is doing anything other than bumping along the bottom. Certainly, output growth appears currently to be weaker than had been anticipated a few months ago. Particularly discouraging were the latest revisions to UK GDP, which revealed a much larger contribution to third quarter output growth from inventory accumulation than was indicated previously. In addition, the level of nominal spending, which is a potentially more relevant variable for monetary policymakers, was revised down by 0.7%.

Disappointing news from service sector and retailers

Looking ahead, puzzlingly strong construction output in October could imply a stronger (or more likely a less weak) headline reading for fourth-quarter GDP than many have recently been forecasting; but there was disappointing news from the much larger service sector (77% of UK gross value added) which saw activity in October no higher than it had been on average in 2012 Q3. Similarly poor figures have recently emerged from the retail sector, where the volume of spending appears to have declined in the final three months of the year.

International background is mixed at best

Outside of the UK, the economic environment is mixed. The trough in Chinese growth appears to be behind us, but emerging world growth more generally does not look set for a strong revival. If anything, the persistent slowdown in broad money growth in emerging markets (EMs) over the last six months suggest that sub-par rates of

economic expansion in EMs should continue for a while yet. At the time of writing, there was no agreement amongst US politicians on how to deal with the 'fiscal cliff'. A messy compromise is ultimately likely to be reached, which prevents a retrenchment worth 5% of GDP impacting the economy in 2013; but US economic activity will still be restrained by relatively sizeable fiscal tightening over the coming quarters. Improving US monetary conditions suggest private domestic demand should continue to grow at a reasonable clip in the face of this tightening, albeit we may still be some way from consistently above-trend output growth. The main external threat to the UK economy comes from the Eurozone, which is a long way from safety despite appearances to the contrary. Activity is still declining, and investor confidence could easily be shattered, as Europe's politicians approach one of the many hurdles they still have to clear.

Persistently sluggish demand growth saps supply side potential

Given the dangers to Britain's long-term supply potential from persistently sluggish demand growth, there is a strong case for erring on the side of doing too much at this stage with monetary policy. The on-going regulatory barrage faced by UK banks, despite the potential benefits it may bring in terms of long-term financial stability, is undoubtedly constraining private sector spending, and more importantly the rebalancing of capital and labour resources within the UK economy. Since politicians of all stripes are swinging behind a 'punish the banks and bankers' agenda, monetary policy has to do the heavy lifting. The FLS appears to be having some effect at the margin in easing credit supply, particularly in the mortgage market. However, additional Bank of England asset purchases would seem warranted. Despite the recent increase in UK broad money growth, it is not yet at a rate consistent with the pace of nominal demand growth that seems desirable. With such uncertainty hovering over macroeconomic policy in the world's major economy, there would seem to be a strong argument for postponing a final decision until next month. But barring any major surprises, another round of QE is likely to be necessary very soon.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold Bank Rate.

Bias: Maintain asset purchases at £375bn; only increase the total to offset declines in M4^{ex}.

UK monetary policy is not as easy as it looks

Why is the British economy refusing to respond to a supposedly very stimulatory monetary policy after failing to react to a very large dose of fiscal stimulus? On the monetary side, the answer is that policy is not what it appears. Macro-economic textbooks take it for granted that lower interest rates – or a near-zero Bank Rate – will lead to easier monetary or credit conditions, but this is not always true. If the demand for credit falls (or the credit demand curve shifts to the left) more than the increase in supply (typically a rightward shift in the supply curve), then it is entirely possible to have very low interest rates and a negligible increase in bank credit. Broadly this summarises the situation in Britain today. First, households have drastically cut their willingness to borrow because: with house prices down 24% in real terms since their peak in 2007 Q3, new full-time jobs scarce, and income growth weak, their ability to repay mortgages or other debt has fallen sharply. Second, larger companies are able to borrow more cheaply and for longer terms in the bond market than directly from banks. Third, the banks are hardly growing their balance sheets at all due to their need to reduce their dependence on borrowed (i.e. non-deposit) funds and to improve their capital ratios. In fact, official data show total sterling assets and liabilities have declined from £4.066 trillion in January 2010 to £3.644 trillion in October 2012, a fall of

10.4%, with most of that decline occurring in the first half of 2010. Since then bank assets and liabilities have remained essentially unchanged, exactly replicating the experience of Japanese banks in the 1990s. In short, Britain has low interest rates but tight credit.

Balance sheet de-leveraging

Given the size of the private sector (the gross liabilities of households, non-financial and financial firms together amount to about fifteen times GDP), it would require an immense injection of money via QE to offset the tendency of all these private entities to contract their balance sheets. In effect, private sector de-leveraging is overwhelming public sector attempts to re-leverage the economy. The clear implication is that the economic recovery may continue to disappoint until the point at which private sector balance sheets are well on the way to repair. Assumptions by the Office for Budget Responsibility (OBR), the Bank of England and others, of a fairly prompt return to 3% growth, are wildly at odds with this analysis. More fundamentally, the lesson for policy-makers is that monetary stimulus can only work effectively in an economy where leverage is not already excessive.

Reduced fiscal stimulus

On the fiscal side, the OBR is projecting that underlying Public Sector Net Borrowing (PSNB) defined to exclude special factors will be £120.3 billion, or 5.1% of GDP in fiscal 2012-13. This might appear to be very large and supportive of private spending. However, it is not the absolute or relative size of the deficit that matters, but the increment in the budget deficit that is the key measure of stimulus. On this basis the years of greatest stimulus were in 2008-09 (when the PSNB increased by 4.3% of GDP) and in 2009-10 (4.3%). Since then the Coalition has deliberately attempted to narrow the deficit: 2010-11 (*minus* 1.6%), 2011-12 (*minus* 1.7%), and an OBR-projected *minus* 2.8% in 2012-13. In other words, the maximum PSNB increases served to prevent the economy suffering an even more catastrophic decline in output in 2008-10, but no such stimulus can now be expected.

Public spending has crowded out the private sector

Like monetary policy, fiscal stimulus also can only work under certain conditions. Typically fiscal stimulus will only be effective up to some indeterminate point where either the level of government debt becomes too large to attract buyers – hence, driving up interest rates as in the peripheral Eurozone economies – or where the scale of government spending and transfers as a share of the GDP becomes counterproductive and inhibits the growth of the private, wealth-generating part of the economy. The judgement of the markets as expressed in the yield on UK government gilts may be unclear. However, the preference of the Coalition for reducing the deficit as a fraction of GDP in the shortest reasonable timeframe is well known, even if the timetable may be slipping a little.

Need for private sector balance sheet repair

If the core problem is damaged household and financial sector balance sheets, then central bank and government policy should be directed to helping the private sector to repair their balance sheets as soon as possible. However, both the traditional policy tools have been maxed out. Monetary policy, which works by expanding the loans and deposits available to the private sector, is blocked because the banks do not want to lend and households do not want to borrow. Of course, low interest rates minimise debt repayment problems, but this is secondary. It still takes households far longer to repair balance sheets than either the corporate or banking sector. Fiscal policy, which works by expanding the liabilities of the government, is blocked because at some indeterminate level of government debt there is a serious risk of driving up interest rates for all borrowers.

Drawbacks of debt forgiveness policies

An alternative approach would be to adopt some form of debt forgiveness, for example by government stepping in to take over (say) half the outstanding mortgage debt of households, and replacing those mortgages on the books of the banks with government debt. However, this creates huge problems of moral hazard. In addition, the distributional effects would be very unfair because it would mean reducing the debt of new mortgagees by much more than those whose mortgages are almost fully repaid. Another problem in modern financial markets is that the mortgage is often no longer on the books of the originator, having been securitised and sold on, possibly several times. Variations of these debt forgiveness or foreclosure forbearance strategies have been attempted in some countries, but without much success. Against this background the Bank of England must learn to pay far more attention than it did in the past decade to the state of balance sheets across the economy. For the present, it should hold Bank Rate stable at ½%, thereby helping borrowers to repair their balance sheets, but be prepared to undertake additional asset purchases if M4^{ex} growth registers absolute declines.

Comment by Graeme Leach

(Institute of Directors)

Vote: Hold Bank Rate and QE.

Bias: Neutral.

New Year a bad time for interpreting economic data

This time of year is notoriously difficult for interpreting the economic tea leaves, particularly as there have been highly mixed reports from individual retailers in the run-up to Christmas and the subsequent New Year sales. January is not the time to jump the gun with a change in interest rates or QE, in the absence of a very clear message from elsewhere in the economy.

UK broad money suggests no triple-dip recession but growth will remain sluggish

The signal from the performance of M4^{ex} broad money performance over recent months is that the UK economy can avoid a triple-dip recession but that GDP growth at a rate above 1% to 1.5% is unlikely during the first half of 2013. If the December and January M4^{ex} figures show a weakening in broad monetary growth, then a further expansion in QE will probably be required. However, and whilst accepting that QE can be employed to support the demand side of the economy, too little attention is being paid to the underlying supply-side weakness as a result of the total government intervention index – this can be defined as the combined impact of public spending, taxation and the regulatory state. Consequently, any increase in money GDP as a result of QE, continues to risk being led more by inflation than real growth. The UK outlook continues to be constrained by the absence of a genuine supply side policy, capable of boosting private capital formation and total factor productivity growth.

Three threats to the global economy

On the international front there are three clear threats to the global economy in 2013. The first is the US fiscal cliff. Second, there is the risk of an intensification of the Euro crisis. The third such threat is the possibility of pre-emptive military activity by Israel or the US against Iran. At the time of writing, the US appeared to be heading over the fiscal cliff, without any agreement between the White House, the Senate and the House of Representatives. Anyone who followed the deficit reduction negotiations during the first Obama administration will know just how far apart the House of Representatives is from the Senate and the White House on this issue. A deal based on substantial tax simplification, which takes an axe to deductions and in so doing permits lower marginal rates and higher overall tax revenues, (plus sharp reductions in entitlement spending) might be attainable in the long-term. However, it seems

impossible to bring this about in a matter of days before the New Year. The political standoff between higher taxes and lower spending seems set to continue. At best, only a short-term politician's fudge is likely to prove achievable as a consequence.

Greek membership of Eurozone is not sustainable and Iranian nuclear threat remains

The Draghi Plan has provided a temporary respite to the Euro crisis. However, it is very unlikely to prevent a Greek exit from the Eurozone at some point over the coming year (*Editorial Note: the reasons are set out in [Still Going Down?](#) in the Institute of Directors [Big Picture](#), Winter 2012, which can be downloaded from www.iod.com). Consequently, precautionary behaviour towards business investment will remain a source of weakness. The final economic threat is a real and present danger. The level of uranium enrichment by Iran is no longer the key issue because the pursuit of weapons grade enrichment has been obvious for years. However, the threat that this enriched uranium will be incorporated in a deliverable weapon is a red line for the US Government, and not just for the Israelis. Consequently, a significant geo-political risk will hang over the world economy in 2013.*

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE.

Strange – and ignorant – debate about monetary policy

One of the strange things about the current debate about monetary policy and inflation targeting is how many of the protagonists, from finance ministers through central bank governors to the International Monetary Fund (IMF) and the Bank for International Settlements (BIS), have forgotten all they were taught about macroeconomics. They seem to believe that monetary policy, now to do with fresh injections of central bank money (QE), can create growth when everyone can fully see the injections from well in advance of the act and long after the original banking crisis has given way to a weak, 'new normal', recovery. Yet even the most 'New Keynesian' model, with long-duration price/wage rigidity, does not predict that money can boost output much in these conditions. A model, on the other hand, with a fair degree of price/wage flexibility is definite that no effect at all on output will result.

Transmission mechanism in New Keynesian models

The main channel through which New Keynesian models see effects on output occurring is through future interest rates being kept low and so stimulating investment, perhaps also consumption. The argument is that the central bank sets interest rates and can influence expectations of where it will set them in future by a special monetary intervention addressed to the future. Nowadays, these models are usually supplemented with a banking sector which charges a premium on its loans that varies with the strength of lending demand. As we have seen, the lending premium has remained stubbornly high in spite of the monetary stimulus applied.

Weak growth, despite massive monetary stimulus

What we have observed here and in the US – and, indeed, in most western economies including the northern Eurozone – is weak growth in spite of massive monetary stimulus. Businesses can see little need to invest, consumer spending is growing slightly, government spending is of course restrained; monetary policy is having little effect on any of these sources of demand. Ironically, the area where it might be having most effect is government where QE, allied to general fear, has brought down the cost of government borrowing to the point that real interest rates

have become negative. Even so, governments are in no mood to commit to new spending levels when they are rightly concerned about long-run solvency.

Activity is weak because prospective returns on capital are low

Accounting for all this weakness is a challenge to our understanding. Some say it is due to 'deleveraging'; in a literal sense this is true as people and firms are not spending and so running down debt. However, this is purely a description not a causal explanation. The question is why they are de-leveraging so relentlessly in the face of low interest rates. To this, the most plausible answer is that prospective returns on capital are low and expected real incomes growing little because productivity growth is slow and promises to remain so. The deep reasons for this appear to lie first in the massive shift in the terms of trade for oil and raw materials against western consuming countries. Indeed, producing countries of the West, such as Canada and Australia, and of the developing world – such as Africa – are in much better shape.

Excessively burdensome financial regulation has undermined credit creation process

The second reason is the regulative backlash against the banking system in the West. This has most effectively blocked the banking channel of monetary policy. It is a commonplace of recent surveys, such as those carried out by the Bank of England through its agents, that Small and Medium-sized Enterprises (SMEs), which account for some 50% of employment and a slightly smaller share of GDP, cannot get loans from the banks on reasonable terms or in some cases on any terms at all. One symptom of this banking channel blockage is the exceptional weakness of broad money growth and the non-existent growth of credit. Governments and regulators are convinced this regulative tightening is both necessary and will make the economy 'safe from crises' in the future. In this they are likely to be quite wrong. This is because capitalism is naturally crisis-prone, since productivity growth is inherently unpredictable and subject to potentially large swings in both directions. Recent Cardiff Business School research suggests that, simply due to these swings, crises of some depth can occur quite regularly and will generally trigger banking problems as well. While our elite classes get to grips with this reality, their heavy-handed regulative intervention is worsening the economic 'supply-side' on top of the weakness induced by the raw material terms of trade shift. Printing money to get over such real supply-side weaknesses will not have much if any effect, as indeed we are observing in practice.

The inflation target and the 'let us have a little inflation' movement

There is increasing talk of raising the inflation target both here and in the US. No less a man than the Bank of England Governor to be, Mark Carney, has made a high profile speech arguing for some 'temporary' raising of the inflation target. He is a bit late in this since the Bank has been indulging in this sport for a few years now, having overshot its target substantially. His reason for suggesting this is that it will boost growth. But, surely, everyone knows the theory of 'time-inconsistency' in monetary policy under which the desire of policy-makers to boost growth by creating extra inflation generates inflation without succeeding in boosting growth? The reason for this is that once people begin to think inflation is being used as a tool for boosting growth they will expect the 'inflation target' to be regularly breached whenever growth is disappointing. They will then calculate how much inflation will seem worthwhile as the price of getting more growth; this rate will then become the 'inflation expectation'. Wage inflation will then rise in line with these expectations and fuel this very inflation rate. Growth in employment and output will not increase as the channel of higher competitiveness (lower real wages) will be frustrated.

Risk that inflation expectations become untethered

One might add that interest rates too will rise as inflation expectations rise. This will not aid recovery and could harm it. It will indeed mean that the value of government debt falls so that the public debt ratio will fall. This can be thought of as the effect of the 'inflation tax'. However, the whole idea of inflation targeting was to make sure governments did not use this tax rather than orthodox taxation; voters disliked the random redistribution generated by high inflation and that underlay the legislative move to the target. So far, inflation expectations have remained moderately anchored in spite of such loose talk. However, authors such as Bennett McCallum have warned that time-inconsistent behaviour is a deep problem of political economy. Those of us involved in the public debate have to be constantly on the watch for its recurrence in ever-plausible guises. It seems that the Carney speech is particularly dangerous as it has been welcomed by George Osborne as the 'start of a debate'. It is a dangerous one. This is because it is one thing to print money when you are committed to reversing it, whenever that may be appropriate, and quite another to have no commitment to reversing it because you are aiming for higher inflation.

Dangers of loose money and talk

In sum, present monetary policy is badly adrift. It needs to be recognised that monetary policy is only a tool of stabilisation in response to shocks. Once the situation has become one of persistently weak growth, monetary policy can no longer have much, if any, effect; it will only drive inflation higher. The only reason the massive loosening of money has had little effect so far on inflation is that: first, the inflation target is still there; and, second, that the banking system has largely killed off money creation as fast as it has occurred because of regulative overkill. Regulative overkill will be with us for some time because of current government fashion. It is undermining growth but we just have to live with that.

Alarming prospect if monetary policy does not return to normal

Monetary policy so far is not causing much inflation. However, it is also not helping growth. All it is really doing is redistributing income from savers to the general taxpayer; this is politically unsustainable even if economically it is just a transfer and so has no clear welfare implication. Nevertheless, if the UK monetary authorities were to move to a commitment to generate growth by printing as 'much money as it takes' and abandoning the inflation target by also by 'as much as it takes', then matters would be alarming indeed. Accordingly, it is really time to get back to normality in the demands on monetary policy and in its behaviour. QE should stop and be reversed over the next year or so. Bank Rate should be raised towards normal levels, starting with a ½% increase forthwith.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Raise Bank Rate by ¼%; hold QE.

Bias: Avoid regulatory shocks; break up state-dependent banking groups; raise Bank Rate, and maintain QE on standby.

The ONS's pre-Christmas data releases

In line with its now-customary pre-Christmas sadism towards the economic forecasting community, the Office for National Statistics (ONS) released a mass of new economic figures on 21st December, which have not yet had time to be incorporated into the wider macroeconomic debate. The new data included not only a revised and more detailed set of GDP accounts for 2012 Q3 but also new third quarter statistics for the balance of payments current account and the general government accounts broken down by sub-sector and economic category. In addition to the new third quarter data, there have been back revisions to previously published official statistics. These have

generally extended back to the first quarter of 2011. The new ONS figures supersede the national accounts data, published on 27th November, which were employed to generate the 5th December OBR forecasts released with the *Autumn Statement* (see: OBR Tables 1.1 and 1.2, which are rounded to the nearest £bn., however). The volume of general government consumption in 2012 Q3, which was the base date for the OBR forecasts, has been revised up from £84.5bn in chained 2009 prices to £84.685bn, for example, while the volume of general government fixed capital formation has been revised up from £7.0bn to £7.384bn. However, there have also been noticeable downwards revisions to the current price figure for general government current expenditure in the third quarter – from £88.3bn to £85.956bn – and for general government fixed capital formation, from £7.8bn to £7.634bn, as the result of revisions to the implied costs of these items. Taking 2012 Q2 and Q3 together, which corresponds to the first half of the 2012-13 fiscal year, the value of general government consumption expenditure has been revised down from £175.9bn to £170.1bn (*minus* 3.3%) and current price fixed capital formation by general government has been revised from £15.7bn to £15.1bn (*minus* 3.5%). These two items make up not quite 54% of total government spending; the rest is mainly transfer payments such as welfare benefits and debt interest. It is conceivable that overshoots elsewhere are offsetting these gains. However, there also remains a chance that the *Autumn Statement* forecasts are slightly too pessimistic on the spending side, even if one suspects that they may also be too optimistic where receipts are concerned.

Plan B advocates have ignored a wide range of empirical evidence and have received more credibility than they deserve

At present, it is almost impossible to discuss the UK fiscal situation without getting sucked into the ‘Plan B’ debate. Plan B advocates have been given more credibility than they deserve. This is largely because of the Chancellor’s failure to mount his soapbox and explain why fiscal retrenchment is so desperately required. In practice, there are at least four sources of economic evidence that are relevant to this debate: the fiscal stabilisation literature; international cross-section/panel data studies; simulations on macroeconomic forecasting models, and direct reduced form statistical relationships between, say, private investment and the budget deficit. None of this massive literature, which has been built up over the past three or four decades, supports the ‘Plan B’ approach, nor has it had a look-in in the UK fiscal debate. In terms of the fiscal stabilisation literature, what Mr Osborne has attempted has been a ‘timorous’ Type 2’ fiscal consolidation programme, in which tax increases were front-end loaded, public investment was cut, and current government expenditure and welfare costs were allowed to rise. There exist countless international studies showing that Type 2 packages lead to unexpected output weakness and a worsened fiscal position, as has happened in the UK. In contrast, a Type 1 package of tax cuts, public consumption reductions, tight control of welfare bills and no public investment cuts – which should have been implemented but was not – is normally associated with positive output surprises, reduced joblessness and an improved fiscal position, particularly if it is done ‘boldly’.

Public spending overshoots mean Mr Osborne is already implementing ‘Plan G’ or ‘Plan H’, let alone Plan B

Furthermore, it is apparent that the volume of general government consumption is running well ahead of Mr Osborne’s original intentions, even if it is difficult to be precise because of the constant re-basing of the national accounts. The first volume projections for the level of general government expenditure were released by the OBR with the November 2010 *Autumn Statement*. At that point, it was believed that the volume of general government current expenditure would have contracted by 2% between 2010 Q2 and 2012 Q3. In the event, it rose by 2.5%, representing a cumulative Keynesian ‘boost’ of 4.5% of government consumption – the equivalent of

1% of real GDP. The implication is that we have already more than received the alleged Keynesian stimulus that Mr Balls has been asking for, but as a consequence of grossly inadequate spending discipline rather than by design. In other words, Mr Osborne is already on 'Plan G' or 'Plan H'. One can only apprehend the day that the financial markets wake up to this reality.

UK growth prospects

In the light of the various 21st December ONS releases, it now looks as if the 'headline' measure of UK real GDP measured at market prices was largely unchanged on average in 2012, while the arguably more informative basic-price measure of non-oil GDP increased by an annual average of 0.2%. After so many 'false dawns', most macroeconomic forecasters are probably too shell shocked to predict a strong recovery in 2013 and subsequent years, even if experience suggests that, once an upswing commences, it tends to be far stronger than anticipated. Furthermore, it is normally several quarters into the new cyclical phase before most commentators realise that the business cycle has turned. For what they are worth, the latest forecasts generated on the Beacon Economic Forecasting (BEF) macroeconomic model suggest that 'headline' GDP will increase by 1.3% on average in 2013, 2.8% in 2014 and 2.5% in 2015. Two reasons for this modest optimism are that UK broad money growth has picked up and that the 2013 prospects for Continental Europe and the US look slightly better than they were in 2012 – despite the likelihood that some peripheral members will leave the Eurozone and that the US will indeed plunge off the fiscal cliff. While on the subject, and as an aside, the mandatory spending cuts that would result from a failure to resolve the US fiscal crisis would almost certainly be economically beneficial in the medium term. It is the prospect of higher taxes that should really scare people because of their adverse effects on aggregate supply. However, damaging tax hikes are likely to occur under President Obama, regardless of whether or not there is an agreement with the Republican majority in Congress.

The UK inflation outlook

The latest UK inflation figures show that the target CPI increased by an unchanged 2.7% in the year to November, while the all-items RPI and the old RPIX target measure increased by 3.0% and 2.9%, respectively. The 'double-core' retail price index – which excludes mortgage rates and housing depreciation and is the most historically consistent inflation measure – rose by 3.0% over this period, compared with the 3.2% recorded in October. The latest BEF forecasts suggest that CPI inflation will ease slightly to 2.4% in the final quarter of 2013 but then accelerate to 3.2% in late 2014 and 4.4% by the closing three months of 2015. There are two proximate reasons for this acceleration. The first is that inflation in the Organisation for Economic Co-operation and Development (OECD) area is expected to accelerate from 2% in 2013 Q4 to 3.5% in late 2014 and 4% by the end of 2015, compared with 1.9% in 2012 Q4. The second is that the sterling exchange rate index is expected to weaken by a cumulated 17% or so between 2012 Q4 and 2015 Q4, amplifying the effects of increased inflation overseas. At a more fundamental level, both developments reflect the long-lagged effects of the long period of ultra-loose monetary policy and supply-damaging fiscal and regulatory actions, internationally and domestically, since 2008.

Need for pre-emptive rise in Bank Rate and robust supply-side measures

Higher inflation could be averted by a pre-emptive rise in Bank Rate during the course of this year – our forecasts have assumed that Bank Rate will be held at ½% until 2013 Q3 - and robust measures to improve supply-side performance; by which, one means genuine public spending reductions, reduced marginal tax rates and a bonfire of regulatory controls, including those on the banking sector. However, it is unlikely that the politicians or the monetary authorities have the stomach for such measures in

most Western democracies. Instead, any official response is likely to be too little and too late, unless the international bond markets get the bit between their teeth and enforce the adoption of the more conventionally orthodox fiscal and monetary policies required for the achievement of economic stability in the longer term.

Nominal GDP targeting is an appealing theoretical idea that could prove a nightmare in practice

Moving on, it has recently been suggested that inflation targeting should be replaced by the targeting of nominal GDP and both the next Bank of England Governor, Mark Carney, and the Chancellor have flirted with the idea – the latter, possibly, because he sees whipping up a pre-election, money-supply led boom as his last political hope for a 2015 general election. However, nominal GDP targeting is an example of an appealing theoretical idea that could prove a nightmare in practice. The facts that government spending is around one half of GDP and that imports are a negative item in the GDP identity means that nominal GDP targets can easily give perverse policy signals, even if one ignores the significant practical measurement problems involved. Targeting private sector domestic expenditure, which is all that monetary policy can influence, would make more sense. However, it remains difficult to disentangle this concept from public sector transactions, given the way in which the national accounts are put together. This is a weakness that could be fairly easily rectified by appropriate action on the part of the ONS, however.

The January Bank Rate decision

As far as the January Bank Rate decision is concerned, the temporarily reduced uncertainties in Continental Europe suggest that there is a window of opportunity to raise rates and that it is now time to introduce a modest ¼% hike in Bank Rate. This is not because of any economic effects that it might have, which would be trivial, but in order to demonstrate that the Bank of England has not just become a supine underwriter of the surreptitious fiscal profligacy contained in the *Autumn Statement*. The medium-term aim should be to get Bank Rate into the 2% to 3% range at which it re-engages with the money market rates that determine borrowing costs. A prompt move to such a Bank Rate during the course of 2013 would help forestall the pickup in inflation seen in the BEF forecasts for 2014 and 2015. International growth studies indicate that both the mean rate of inflation and its standard deviation have a negative impact on the level and the growth of real GDP per head. Recent inflation overshoots have reduced economic activity, not boosted it as some Bank officials appear to wrongly believe.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Hold Bank Rate; diversify existing QE into non-gilt assets.

Bias: To raise Bank Rate.

Diminished hopes for 2013

We begin 2013 with diminished expectations of UK economic improvement. Three new pieces of information have become available over the past month: the contents of the *Autumn Statement*, the first quarterly report on the Funding for Lending Scheme (FLS) and the detailed national accounts for 2012 Q3. None of these has provided comfort on the UK economic situation.

Disappointing Autumn Statement

The principal objective of the *Autumn Statement* appears to have been to make the Shadow Chancellor look foolish. By crook, more than hook, the fiscal deficit projection for the current year retains a downward bias. However, it is surprising, to say the least, that the OBR saw fit to endorse the assumptions that allowed Mr Osborne to avoid the embarrassment of reporting a rising deficit for 2012-13. This is still the most likely

outcome, particularly in the light of the December public finances release. One of the few remaining planks of supply-side transformation, the reduction in the absorption of resources by the public sector, has run aground.

Fiscal and monetary policy failures

The overall stance of the coalition's economic policy, as commonly understood, was to combine fiscal tightening, monetary ease and currency flexibility. Fiscal tightening fizzled out in 2012; monetary ease has been overruled by undesirably tight credit conditions, and our currency has drifted higher in the light of more aggressive monetary policy measures taken elsewhere. Policy implementation rates are poor.

Funding for Lending Scheme has disappointed as well

The FLS is beginning to have a favourable impact on mortgage accessibility, but mainly at the upper end of the income distribution. Unfortunately, it is also having the unintended effect of depressing interest rates on savings accounts as banks substitute cheaper FLS funds for retail deposits. FLS is counteracting the market-driven interest rate increases attributable to Eurozone risk, but does not seem close to the degree of impact hoped for by its architects.

Third quarter GDP figures

The third quarter national accounts confirmed the slump in construction output, weighted towards residential housing (down 14% in the latest quarter) and the bloated contribution of government expenditure and income transfers to the GDP total. Inventories are accumulating while net exports are weakening, not aided by Sterling appreciation. If it had not been for the disbursement of Payment Protection Insurance (PPI) mis-selling compensation, household consumption might not have edged to a 1.3% year-on-year gain in the third quarter of 2012.

Private sector credit system has to operate more efficiently

Ultimately, the restoration of a confident expectation of even a modest pace of economic growth requires the private sector credit system to operate much more efficiently than at present. All policy energies should be directed to this end, since no schemes will succeed on their own merits in the absence of affordable credit and a positive framing of policy. Replacing the governor of the Bank of England should make some difference to the latter, but probably not to the former. Ironically, had Mr Osborne aired the dirty linen of the UK public finances he may well have repelled some of Sterling's fair weather friends. As it is, the UK has the pretence of fiscal rectitude (and has preserved its AAA sovereign rating) but not the reality.

Emulate Japanese QE approach

Finally, rather than Japan taking a leaf out of the UK's policy playbook (in its emulation of FLS), the UK should consider copying the Bank of Japan's purchases of Exchange Trade Funds (ETFs), Japan Real Estate Investment Trusts (J-REITs) and corporate bonds. The leverage obtained from small purchases of beaten-up private sector assets makes far more sense than the massive purchases of (over-priced) government bonds. The Bank of England should be looking to raise Bank Rate through 2013, but it does not seem like now is a good time to start.

Comment by Mike Wickens

(University of York and Cardiff Business School)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate for now.

Should targeting nominal GDP replace targeting inflation?

The most interesting development in the last month has been the announcement that Mark Carney is to be the new Governor of the Bank of England and his reported statement that he favours a change in the way that monetary policy is conducted in

the UK from inflation to nominal growth targeting. Would this be a good idea? It has received much support in the media. It would also crown Sir Samuel Brittan's advocacy for this, which has been conducted in his *Financial Times* column for the last forty-five years. The reason why this old proposal has been resurrected is the recent poor real growth performance of the UK, the US and the Eurozone. The apparent implication is that by targeting real growth instead of inflation, monetary policy would have been different and growth would have been higher. The intellectual underpinnings for the use of monetary policy to target economic growth may be attributed in modern times to Milton Friedman's claim that monetary policy is more effective than fiscal policy in stimulating output in the short run. The stylized statistic is that the stimulatory effect of an increase in the money supply lasts for about eighteen months. In contrast, estimates of the fiscal multiplier have steadily fallen: it was assumed to be between 1 and 2 during the high days of Keynesianism in the 1960s when the UK had a fixed exchange rate, it is now estimated to be much less than 1.

Academic literature has suggested that inflation targeting minimises welfare losses

A serious analysis of the relative effectiveness of monetary policy and fiscal policy as implements to increase economic growth would need to take into account the particular policy instruments being considered (e.g., interest rates or one of the many measures of the money supply; current or capital government expenditures), methods of financing deficits (tax, debt or money), whether the exchange rate is fixed or floating and the state of the economy (full or under employment). There is also the issue of how much risk should be transferred from the private to the public sector in order to increase investment spending. Until the financial crisis, the monetary history of the UK under a floating exchange rate had pointed to the efficacy of inflation targeting compared with trying to control the money supply or targeting a nominal exchange rate such as the former Deutschmark. Moreover, the academic literature favoured focusing solely on inflation (strict inflation targeting) over also taking into account economic growth (flexible inflation targeting) because this was thought to minimise the welfare loss to the economy from fluctuations in both inflation and output. This implies a rejection of targeting nominal growth as this would give an equal weight to inflation and output growth.

But there are problems with inflation targeting when faced with supply shocks

Nonetheless, strict inflation targeting is not without its problems. It is, for example, much better suited to dealing with a positive demand shock (which raises both inflation and output) than a negative supply shock (which raises inflation but reduces output). Raising interest rates following a positive demand shock would, as required, reduce output and inflation but, following a negative supply shock, not only would it reduce inflation but output too. A second problem is the zero lower bound on interest rates. Both constrain the ability of interest rate policy to stimulate the economy. These limitations have been evident in the current recession and have undermined the effectiveness of monetary policy. For example, real GDP in the UK has fallen by 2.9% since the end of 2007, while nominal GDP has grown by 8% and CPI inflation has averaged 3.5% per annum. This appears to be evidence of a classic negative supply shock. Other examples of a negative supply shock in the UK were in 1974/5 following the oil price hike, when inflation rose to over 26% and output fell by 1.5% and in 1980/1 when inflation rose above 17% and output fell by 3.2%.

Bank of England has not followed its inflation target in recent years

The implication of this discussion is that the case for switching to nominal income targeting must rest largely on its ability to raise output following a negative supply shock as this is when strict inflation targeting is least effective. It is clear, however, that the monetary policies pursued during the current recession by the Bank of England,

the US Federal Reserve and, to a lesser extent, the ECB, have had little to do with strict inflation targeting. The Bank has not responded to inflation by raising interest rates (as strict inflation targeting would require) even though inflation has been double its target value. Rather, it has kept interest rates at an historic low, and has accompanied this with a large expansion of the money supply via QE - in effect, open market operations. It is difficult to think of how a monetary policy geared to nominal growth targeting could have done more. The Bank of England has never even claimed to be a strict inflation targeter. It has always taken a close interest in output, if only because it took the view that interest rates affected inflation through their effect on output. It is also able to choose how fast to bring down inflation, and hence how much to curtail output in the process.

No advantage in switching to nominal growth targeting

To sum up, there seems to be no advantage to switching to nominal growth targeting. Indeed, it could make matters worse if taken too seriously because inflation takes time to adjust and, if the aggregate rate of price increase is high, it may be necessary to engineer a deep recession to achieve the nominal growth target. In my view, it is better to give priority to controlling inflation with the aim of maintaining longer-term inflation expectations – but to permit inflation to exceed its target in a recession. In short, the Bank should continue to do what it does now. This is not, however, all that can be said about the operation of monetary policy. Perhaps the most important feature of the Bank of England Act of 1997 was that it sought to make monetary policy independent of fiscal policy and of political interference. Optimal macroeconomic policy aims to control inflation and stabilise economic growth, though not by targeting nominal growth. A combination of monetary and fiscal policy is therefore required. Consequently, given the Act, fiscal policy should take on a large part of the burden of stabilising output particularly when, as now, the Bank has run out of monetary policy options and appears to be impotent to raise output further. For example, the possibility remains of injecting a further monetary stimulus via fiscal policy by temporarily money financing part of the deficit – in effect a ‘helicopter drop of money’. In this way the continuing expansion of debt could be halted and, if clearly understood to be a temporary expedient, inflation expectations may not be greatly affected. Perhaps this is what Friedman had in mind.

Comment by Trevor Williams

(Lloyds Banking Commercial Banking)

Vote: Hold Bank Rate and keep QE at £375bn.

Bias: Neutral.

UK ended 2012 with little or no growth impetus

The evidence so far suggests that the UK economy seems to have ended 2012 with little or no growth impetus. The Purchasing Managers’ Indices (PMIs), for construction and manufacturing remain below 50, whilst the services PMI remains only a little above, suggesting that output contracted in the final quarter of 2012. Output remains about 4% below the peak level seen in 2008. Taking the five years to 2012, the economy has been flat. This represents easily the worst recovery from recession since World War II and a grim reminder that the issues facing the economy are more structural than cyclical. For comparison, the UK economy has barely performed better than Spain since 2008 and worse than France, even though the UK is not in the Eurozone. Indeed, the UK has the poorest growth record of any of the G-7 leading economies, relative to its trend rate of growth prior to the economic crisis. On even optimistic growth scenarios, the UK economy is unlikely to regain its pre-recession

level of output until 2015 at the earliest. It is clear that the UK has entered a low-growth, low-wage inflation trajectory since 2007. The former could be described as pay back for the roughly decade long debt fuelled growth that now has its apotheosis in the deleveraging that companies and households are now undertaking, which means they are not spending.

Fiscal policy has shot its bolt and government has to deleverage too

With consumer spending constrained by a lack of desire to borrow, and companies sitting on cash rather than investing, low growth seems the only outcome since fiscal policy cannot offset this loss of consumption. The government now has to deleverage too – or, at the least, promise to do so in the medium term – if it is not to face a rise in borrowing costs. Furthermore, low interest rates will not ‘solve’ the problem either, since this is a problem of excessive debt that only debt reduction can resolve. It does help to mitigate its effects, however, as it allows the repayment amounts to be low and keeps down defaults, thus preventing an even greater desire to save and a worse retrenchment.

Workers have maturely accepted lower real wages to preserve their jobs

However, the problem is deeper than demand, as the fall in the exchange rate has not prevented a rise in the UK’s current account deficit to some £55bn in 2012 after a narrowing to £20.4bn in 2011 from £37.4bn in 2010. Weak growth should have meant some decline in the deficit, although the recession in the UK’s key export markets is an offsetting factor. Low wage inflation is one response to this, as it allows UK firms to be competitive, or at least more competitive than would be otherwise the case. It is also a positive for the UK’s economic prospects, as it signifies that people are willing to take cuts in real pay to offset the collapse in productivity, which is over 4% lower now than in 2007. If it had risen at the same pace as prior to the 2007 crises, it would be some 8% to 10% higher.

Worsened current account deficit implies supply-side problems

A rise in the UK’s relative costs has not been offset by increased efficiency of labour or capital so leaving the economy vulnerable to shocks from abroad, of which inflation is just one example. This might be down to the trend decline in North Sea output and the subsequent rise in real energy costs for UK firms. However, and whatever the source, the widening in the current account deficit and fall in productivity are clear signs of a problem on the ‘supply’ side of the UK. Other ‘supply’ side candidates are a tighter regulatory burden or too high a share of government spending in GDP. It is promising though that at least the labour market has responded by showing a willingness to accept cuts in real take-home pay. The boost that this development has given to employment suggests that the UK is willing to work hard to get its economy back on track.

UK’s ‘new normal’ growth rate may be between zero and 1%

A rise in the domestic money supply, together with improved growth in the emerging markets and the US in 2013, should give the UK economy some prospects of recovering, albeit at the ‘new normal’ rate of 0% to 1%. In this environment, low interest rates are essential, as is a commitment by the authorities to reduce the fiscal deficit in the medium term. Asset purchases should be resumed if broad money (i.e., $M4^{ex}$) looks as if it is falling once again, but otherwise should remain at £375bn.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (University of Derby and Beacon Economic Forecasting). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Banking Commercial Banking). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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